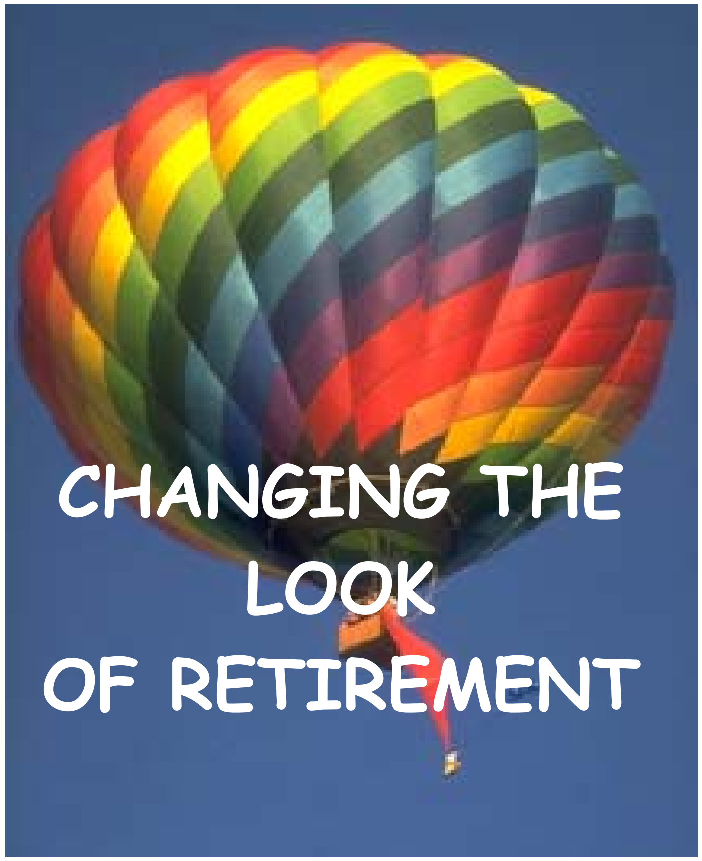

WISCONSIN TRANSITIONAL RETIREMENT STUDY

Prepared by the
Department of
Employee Trust Funds
March 2001

This report identifies possible changes to the Wisconsin Retirement System that could assist members in making the transition from career employment to full-time retirement on a schedule that meets their individual economic and social needs. The report examines the considerations faced by public employees as they near retirement eligibility and acknowledges the increasing interest of employers in attracting and retaining experienced workers once they reach retirement age.

The report explores limitations in the design of many defined benefit plans that discourage older workers from gradually moving from their career position to full-time retirement. Alternative approaches used by some plans and other, new opportunities for plan design in which the value of accumulated benefits can be protected during such a transitional period are discussed.

Increasingly, both retired employees and employers are interested in reestablishing a working relationship. "Return to work" barriers facing public workers and employers, as well as relevant public policy considerations, are described.

For many retirement aged members, a "phase-down" into retirement through part-time work is not possible without a supplemental income stream. The report looks at this problem and identifies possible options for addressing this need.

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This report includes:

The Department of Employee Trust Funds is responsible for administration of the Wisconsin Retirement System (WRS). This system is a qualified retirement plan under Section 401(a) of the Internal Revenue Code. Most public employers in Wisconsin, including universities and school districts are part of the WRS. The Department is also responsible for the administration of several other ancillary benefit plans such as the Section 457 deferred compensation program, insurance programs (health, life and disability) and an employee reimbursement account under Section 125.

CHANGING THE LOOK OF RETIREMENT

INTRODUCTION

Certain terms used in this report (in bold type) are defined in the glossary at the end of this report.

The Department of Employee Trust Funds conducted this study to examine the changing needs of public employees in Wisconsin as they near retirement. Many factors are reshaping the look of retirement, including:

- *An aging workforce - the* ***baby boom generation*** *makes up more than 50% of civilian employees nationwide[1]; this generation comprises more than 60% of public employees in Wisconsin.*

- *Increased life expectancy - medical advances have extended life expectancy as well as the quality of life for seniors who are living much more actively in retirement.*

- *Greater need for financial security during retirement - increased health care costs as well as living expenses for the more active senior life style have resulted in higher income needs during retirement years.*

- *Shrinking labor supply - the public sector will likely be the hardest hit when the baby boom generation moves into retirement.*

Whether for economic, social or other reasons, a large percentage of future retirees will hold "transitional" jobs as they gradually move into retirement. Transitional or **"bridge" jobs** are often described as either part-time or full-time employment, frequently in a new line of work, during a one to seven year period immediately prior to retirement. These positions allow employees to gradually shift from a career occupation into full-time retirement. It is estimated that between one-third and one-half of baby boom generation workers will hold a bridge job[2].

Employee expectations of continued work after retirement is also significantly increasing as evidenced by a recent survey that found 67% of today's workers expecting to work for pay after retiring while only 25% of those currently retired had worked for pay since retirement[3]. Seventy-five percent of current retirees cite the reason for returning to work as they enjoy work and want to stay involved. Between 20% and 30% indicated income or paid benefits, such as health insurance, as their reason for working after they retire.

Changing retirement patterns are occurring at the same time employers are experiencing worker shortages. This problem is expected to become more widespread in future years as the baby boomers begin retiring. According to Department of Labor statistics, many of the occupations that will see the greatest loss as a result of retirement between 2003 and 2008 will be in public employment, such as education, public administration and social work. Thus, opportunities for employment, whether part-time or full-time, will continue to abound for retirement-aged workers.

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[1] The Segal Company - *The Aging of Aquarius: The Baby Boom Generation Matures*, February 2001
[2] Employee Benefit Research, Inc. - Issue Brief #206: *Retirement Patterns and Bridge Jobs in the 1990s*
[3] Employee Benefit Research, Inc. - *The 2000 Retirement Confidence Survey*

A key question, therefore, is what retirement benefit design(s) can best accommodate the interest in transitional employment by retirement-aged workers and also enable employers to retain the talent and experience offered by this group? Other important questions involve the regulatory limitations that prevent such design, the cost of changes to existing plans, and the acceptance by the public and policymakers of options that could involve partial retirement distributions while continuing to work. The Wisconsin Retirement System (WRS) already provides excellent traditional retirement benefits, but should it do more?

What We Have Found

There are many inherent barriers in the design of primary and supplemental retirement plans that limit the ability of employees who wish to phase into retirement or return to work after retirement. Federal laws regulating these plans also impose restrictions on the ability of employers to design plans that better meet the changing needs of employees. This study identifies some of the barriers within the WRS benefits structure and possible solutions to provide greater flexibility for retirement-age members to choose alternate paths for a comfortable transition from work to retirement on a timetable that meets their individual social and economic needs. To illustrate the study's findings, this report includes:

- ***Chapter One - The Wisconsin Retirement System***, provides background on the WRS structure and the ancillary benefits offered to Wisconsin public employees.

- ***Chapter Two - Overview of Issues***, discusses the issues relating to transitional retirement initiatives and the barriers inherent in the WRS benefit structure.

- ***Chapter Three - Protecting the Value of Retirement Benefits During a Bridge Job,*** identifies barriers that restrict employees' ability to alter their work pattern in the years immediately before retirement and possible changes to the WRS structure to protect the value of benefits during a bridge job.

- ***Chapter Four - Improving Opportunities for Returning to Work After Retirement,*** discusses the issues surrounding the ability of a retiree to return to work with a public employer in Wisconsin and possible approaches that can be initiated to remove or reduce certain barriers **rehired annuitants** face.

- ***Chapter Five - Creating a Supplemental Income Stream for Transitional Retirement,*** examines different possibilities for providing an income stream to supplement bridge employment to employees not yet ready for full retirement but unable or unwilling to continue in their career position.

- ***Chapter Six - What's Next for Wisconsin,*** this report is just the beginning of the efforts to look at changes to the WRS benefit structure to offer flexibility to its participants and to establish a more personalized approach to retirement. Additional review of federal tax laws is needed to identify compliance issues as well as an actuarial study of the benefit proposals to determine the potential costs and/or savings.

THE WISCONSIN RETIREMENT SYSTEM

This section provides a brief overview of the structure of the current Wisconsin Retirement System (WRS) to better understand transitional retirement issues in the WRS and potential opportunities for changes.

The Wisconsin Retirement System (WRS) is a multi-employer qualified retirement plan under Section 401(a) of the Internal Revenue Code. With few exceptions, the employees of the State of Wisconsin, University of Wisconsin, local government employers, as well as technical colleges and school district employers are included in this system.

The WRS is a hybrid pension plan with both **defined benefit** and **defined contribution** components. Although structured as a defined benefit plan, separate individual accounts for all **participants** are also maintained. **Employee required** and **employer contributions** change as determined by the actuary and the former are recorded directly on individual participant accounts. Annual interest adjustments are also added to each participant's account balance that are either based on the earnings of the trust or a pre-defined interest adjustment mandated in Wisconsin statutes[4].

Because of the hybrid design, a participant's retirement benefit is calculated based on:

1) a defined benefit formula - uses the three highest years earnings to calculate the final average earnings and the number of years of WRS creditable service to determine the benefit; an **actuarial reduction** is applied if the benefit begins before the employee attains **normal retirement age** or a specified age and number of years of service (e.g., for general employees this is age 57 with 30 years of service); AND

2) a **money purchase** (defined contribution) benefit - calculated based on the value accumulated in the participant account at the time of retirement and matched equally with an amount from the employer reserve; although an actuarial reduction is not directly applied based on the employee's age[5], a **minimum retirement age** must be attained to be eligible for any WRS annuity benefit (e.g., age 55 for general employees).

The retirement annuity a participant receives results from the calculation that provides the greatest benefit. At the time the retirement benefit begins, the amount that is necessary to fund the lifetime benefit (based on actuarial assumptions of duration and investment earnings) is transferred from the employee and employer reserve into the **annuity reserve**[6]. Each year,

[4] WRS participants who began their retirement coverage prior to 1/1/82 receive the full effective rate interest credit applied to the WRS account balance while those whose coverage began on or after this date receive a pre-set annual interest adjustment of 5%. Legislation enacted in1999 (Wisconsin Act 11) reinstates full interest credits to all participants. However, this law has been enjoined pending a determination of its legality by the Wisconsin Supreme Court. A final ruling had not yet been made as of May 1, 2001 and implementation of this legislation is still on hold.
[5] The monthly benefit is calculated based on actuarial factors using applicable mortality tables.
[6] WRS trust assets are recorded in three separate pools. The employee reserve holds the amounts directly credited to employee accounts; the employer reserve includes the employer match to the employee credits as well as an additional sum that is actuarially determined to be necessary to fund formula benefits; and annuitant reserve to fund payments to annuitants and beneficiaries.

retirees receive a **dividend adjustment** applied to their monthly annuity payments that is based on the actual investment return of the WRS trust applicable to the annuity reserve.

To be eligible to begin a retirement benefit under Wisconsin Statutes, the employee cannot return to employment with the same or any other **participating employer**[7] for a minimum of 30 days from the effective date of the benefit. Once a benefit begins, if an **annuitant** returns to work to a covered employer within this 30-day period, the benefit will be canceled and the original account reestablished. If after 30 days or more, the annuitant returns to work for a participating employer, he cannot become a WRS **active participant** again (with new contributions to the system) unless the annuity is stopped and the original account is reestablished. However, the rehired annuitant can cancel the annuity and reestablish the original account at anytime.

<u>Ancillary benefits are part of the WRS benefit structure</u>

The WRS benefit structure, administered through the Department of Employee Trust Funds, includes several ancillary benefit programs. These include:

- ***Disability programs***: long-term disability insurance is part of the WRS benefit and all participating employees are eligible; a short-term disability insurance is available to all State and University employees, as well as employees of local governments that elect participation in this plan.

- ***Health insurance programs*** - all State and University employees are eligible, as well as employees of local governments participating in the WRS that elect participation in this plan.

- ***Life insurance program*** - all State and University employees are eligible, as well as employees of local governments participating in the WRS that elect participation in this plan.

- ***Deferred compensation program*** (under Section 457 of the IRC) - all State and University employees are eligible, as well as employees of local governments that elect participation in this plan.

- ***Employee reimbursement account program*** (under Section 125 of the IRC) - only offered to State and University employees.

- ***Accumulated sick leave conversion account program*** - only offered to State and University employees; this program allows the value of accumulated sick leave to be retained in an account at retirement to pay retiree health insurance premiums on a non-tax basis.

In addition to restrictions on participation in the WRS, current Wisconsin statues also restrict a rehired annuitant's eligibility for ancillary benefits including disability, health and life insurance programs and also the accumulated sick leave conversion credit program. As with WRS eligibility, the rehired annuitant is only eligible for these insurance benefits through the WRS[8] as an active employee if the annuity is stopped and the original account is reestablished. Participation in the deferred compensation and employee reimbursement account programs is

[7] This includes any of the 1,300 employers that are part of the WRS multi-employer system
[8] This applies to state and university employees. Local government and school district employers may provide some paid benefits to rehired annuitants.

not restricted and the rehired annuitant can elect participation in these plans based on the continuing employment.

The sick leave conversion program poses unique issues relating to transitional retirement decisions. This program provides state and university employees with an opportunity to fund retiree health insurance premiums as follows:

- The balance of the accumulated sick leave account, accrued while an active employee, is converted to a dollar value by multiplying the number of hours remaining at retirement by the employees final hourly rate of pay.

- For employees with at least 15 years of creditable service, the state provides a supplemental payment (e.g., match) of a certain number of extra hours for each year of creditable service; this value is also calculated based on the final hourly rate of pay.

- To be eligible for this balance, the employee must be eligible for, and begin, an immediate annuity from their WRS account (unless under certain conditions as prescribed in statutes, the employee is eligible to escrow the balance).

The design of the WRS total benefits structure offers unique opportunities for creating new plan features that can better meet current and future retiree needs.

TRANSITIONAL RETIREMENT - OVERVIEW OF ISSUES

This chapter provides an overview of the issues surrounding the development of a transitional approach to retirement and the barriers that are inherent in the WRS design.

The aging of the workforce is changing employee demographics and hastening the need to reshape retirement options. The baby boom generation makes up the largest segment of today's working population, with the oldest starting to prepare for retirement. In 1980, half of American workers were under 35 years of age. In 2005, it is anticipated that age 41 will be the midpoint[9].

In Wisconsin, 61% of public employees covered by the WRS are in the baby boom generation. Approximately 30% are early baby boomers (those born between 1946 and 1953) and will likely begin retirement over the next one to seven years. In comparison, the succeeding generation, **Generation X**, makes up less than 24% of the WRS active population. The graph on the right illustrates current public employee demographics by age. Exhibit A provides additional information regarding Wisconsin demographics.

Employees are considering retirement at even earlier ages. The good news for employers who will be facing increasing labor shortages in the coming years is that more employees are also likely to seek work after retirement. For this reason, employers must reexamine their retirement and benefits structure to address the changing needs of these older workers. Keeping employees longer, such as in bridge jobs, or providing return to work opportunities for retirees will be a priority for maintaining an adequate workforce.

Federal Regulations

The need for a pension plan to provide a transitional or phased retirement approach has gained national attention. Federal legislation was introduced last year to amend the Internal Revenue Code (IRC) governing qualified pension plans to permit in-service distributions from defined benefit plans at the earliest of the following: 1) age 59½, 2) 30 years of creditable service, or 3) the plan's defined normal retirement age. There is some indication that this legislative initiative has continuing support and it may again be introduced in a future legislative session. This change, if implemented, will provide even more opportunities for employers to meet employees changing retirement needs, but does this do enough?

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9 The Segal Company Report, *The Aging of Aquarius: The Baby Boom Generation Matures.*

Changes to the federal tax code to provide even more flexibility to employers as they look to structure retirement benefits to better meet the changing employee environment may be appropriate. Additional flexibility could include:

1. Allow all types of qualified retirement plans [defined contribution, defined benefit, hybrid] to provide in-service distributions to employees who have reached the earliest age of eligibility to elect a benefit (such as life annuity) from the plan.

2. Allow in-service distributions from supplemental retirement plans, such as Section 457 deferred compensation plans and Section 403(b) tax sheltered annuity plans, at a specified retirement age that begins at the earlier age identified in #1 above.

Public Policy and Perception

Another issue public employers must address as they reexamine their retirement policies is the perception that receiving retirement benefits at the same time as a government employee also has income from employment is "double dipping". In some retirement systems, the perception may result from their mechanism for funding benefits (all assets held in one trust fund pool - both current employer contributions and annuity reserve assets). The employer contribution level to fund future benefits may be affected by the reduction of new employees as more older employees are retained (as re-hires) and any cost-of-living adjustments added to current annuity payments funded by contributions. With this approach, it may be difficult to assure that a rehired annuitant is not affecting the actuarial valuation for calculating funding levels.

In Wisconsin, however, three separate asset reserves are maintained (annuitants, employers and employees), and issues such as annual dividend adjustments to annuitants have no bearing on employer contribution levels. When an employee begins his WRS retirement benefit, the assets to fund this are moved into the separate annuity reserve. The annual dividend amount paid to annuitant accounts is based on the earnings of the WRS trust that are assigned to the assets in the annuity reserve. Therefore, although the perception of “double dipping” (simultaneously receiving retirement benefits and a paycheck) still exists for some, there actually is no material financial effect to employers relating to increased contributions for all employees as a result of a WRS annuitant receiving both current income and a retirement benefit.

Adopting a policy that promotes opportunities for current public employees to remain in service longer, or return to work after retirement, can be justified. Retirement systems are established for two purposes:

1. *To provide long-term employees with income during retirement years that is commensurate with career earnings and rewards them with financial stability during retirement.*

2. *To allow the employer to compete in the job market to attract and retain skilled workers.*

Public retirement systems frequently have different objectives in the design of employee benefits than private employers. Although employer needs and issues are always a consideration, the needs of employees are typically at the forefront. For this reason, it is not surprising that more government employers have been examining transitional, or phased retirement options for a number of years. Programs such as deferred retirement option plans, or DROPs, are becoming very popular particularly among universities and school districts as well as protective service fields (police and fire). Flexible work schedules before retirement have also been promoted as an option to meet phased retirement needs.

These approaches, as well as others that have been identified in this study, address the changing needs of our current and future retirees. The proposals outlined within this report can provide additional opportunities to public employees to personalize their retirement pattern. These proposals also provide opportunities for public employers in Wisconsin to remain competitive in this tight job market by retaining older, experienced employees who might otherwise be lost through retirement.

Barriers to a Transitional Retirement Approach

There are inherent barriers in the design of a traditional pension plan that restrict or limit the ability of an employee to gradually shift into retirement. A defined benefit structure will often use the three years with highest earnings in the benefit calculation. This will reward employees who have high income during the final years of employment (regardless of their earnings in earlier years) but, potentially, harm those who reduce annual earnings in the years immediately before retirement.

For example, in a traditional employment scenario, the final years of an individual's career will be the peak earnings period, and thus used in the retirement benefit calculation. As more employees seek to phase into retirement by accepting a bridge position that may result in a lower hourly rate of pay or reduced hours, their highest earnings period will likely be three to five years before retirement. This earlier period is then used in the final average earnings calculation upon which the benefit is based. Because inflation has already eroded the earnings from these earlier years, the resulting retirement benefit will provide significantly less income than the retiree would otherwise expect to receive based on the earnings from the career employment.

Another system barrier is the restrictions imposed on an employee's ability to return to work for a covered employer once a retirement benefit has begun. Some systems prohibit this entirely by terminating the benefit should the retiree return to work. Others impose a maximum number of hours (e.g., 600 hours) or length of time (e.g., 3 months) that can be worked while receiving a benefit. Although not as restrictive as some systems, the WRS requires that employees be terminated for a period of at least 30 days to be eligible to receive a benefit and return to work with their current employer or any other public employer covered under the WRS. Additionally, employees cannot have an agreement with any WRS employer to return to work before termination occurs.

Retirees returning to work with a public employer also are restricted as to the benefits that they receive as a rehired annuitant. Unless they elect to stop their benefit and reestablish their WRS account, rehired annuitants receive no credit under the retirement system for the new employment, even if this position would be covered if held by a non-annuitant. Other employer paid benefits, such as health, life and disability insurance, are also normally not provided to a rehired annuitant. These barriers often encourage retirees to seek employment outside the public employment arena and restrict their ability to phase into retirement.

Employees who are unable to afford the reduced income from a bridge job are also limited in their ability to gradually shift into retirement. For employees who do not have supplemental income from savings or other outside resources, they may have no choice but to continue working in their career position beyond the time they feel mentally or physically able to handle the job. Their only other options may be to retire early and then return to employment as an annuitant (after the mandatory break-in-service) or seek employment with a private employer.

Neither of these choices may be the most advantageous to either the employee or the employer. For the employee, continuing to work in the current position may be problematic while beginning a full retirement may provide more income than is needed during a bridge job. The employer may prefer to retain the skilled employee, but perhaps in a modified or reduced position.

Study Findings

The age an employee elects to begin a transitional retirement period will vary based on the physical, mental and financial health of the individual (or family situation) as well as the career occupation. Although the examples in this study have concentrated on employees who are between the age of 55 and 60, for some the transitional period will begin at a much earlier age.

The following is a brief summary of the study findings that will be detailed in the remaining sections of this report.

- The WRS defined benefit value may be negatively affected as a result of a bridge job that has a significantly reduced annual income. The following are two different approaches examined for protecting the retirement benefit.
  - Create a deferred retirement option plan, or DROP, that is structured as a new benefit payment option in the WRS.
  - Convert the defined benefit formula value at the beginning of bridge employment to a money purchase, or defined contribution, benefit, thereby allowing the account value to continue to grow with investment earnings.

- Public employees in Wisconsin are limited in their ability to return to work with the same or different public employer after retirement. Changes to the WRS and current federal tax laws have been explored to provide additional flexibility for retirees to be able to return to work that include:
  - Remove the break-in-service requirements for employees who have attained normal retirement age or are switching between public employers.
  - Provide employer paid benefits to rehired retirees.
  - Establish continuing retirement credits for rehired retirees either within the current system or in a separate retiree plan.

- Some employees are not financially able to accept a bridge job that will reduce annual income, but also are not yet ready to begin their retirement. Creating the ability to generate an income stream while employed in a bridge job through the primary or supplemental retirement account provides additional opportunities for these employees to phase into retirement. Solutions identified to address this include:
  - Establish a new benefit payment option in the WRS to provide a small supplemental bridge benefit during transitional employment that converts to a full benefit when retirement begins.
  - Allow in-service distributions from the supplemental Section 457 plan at normal (or earliest) retirement age or through a loan provision.

PROTECTING THE VALUE OF RETIREMENT BENEFITS DURING A BRIDGE JOB

A bridge job with lower annual earnings can reduce the value of the WRS formula retirement benefit.

Transitional retirement can result in the erosion of the value of the WRS formula benefit because the three years with highest earnings are used in the benefit calculation. This rewards employees who have high income during the final years of employment (regardless of their earnings in earlier years) but can have the reverse effect for those who have reduced annual earnings as a result of a bridge job in the years immediately before retirement.

Unlike traditional career employment, where peak earnings are normally the final years of earnings, someone who chooses to phase into retirement through a bridge job will likely find that the highest earnings period is three to five years before retirement. This is the period that will be used in the final average earnings calculation upon which the benefit is based. Because inflation has already eroded the earnings from these earlier years, the resulting retirement benefit will be less than would be expected had the career employment continued.

In some cases, the actual annuity payments after the bridge job can be less than the amount the employee would receive had he or she retired before the change in employment began. This is because the expected **annual dividend** amount credited to the annuity payments each year has a greater impact on the benefit than the credit that would be added to the **annuity** from the additional years of service.

Two possible approaches that could be initiated within the WRS benefit structure to protect the value of the retirement benefit during a bridge job are:

- Establish a deferred retirement option plan (DROP) as a new distribution choice in the WRS. A DROP allows an employee to lock in the value of his or her benefit before beginning a bridge position and delay receipt of payments until the actual retirement date. When a DROP benefit is elected, the payments that would otherwise be paid to the employee are recorded in a separate account. This account will earn interest until the final retirement date and the employee can either receive this balance as a lump sum or convert it to a monthly annuity to enhance the benefit that was "locked in" at the start of the DROP.

- Convert the defined benefit formula value to a money purchase (defined contribution) amount at the time an employee begins a bridge job. While employed in the bridge position, the employee’s account continues to be credited with contributions (based on the bridge employment) along with the annual interest adjustment. The final benefit is then calculated based on the balance in the account on the **effective date** of the retirement.

This section of the report describes the above two options in more detail and identifies the advantages and disadvantages of each approach.

Background

Because the WRS is a hybrid system, with both a defined benefit and defined contribution component, the first step in the analysis determined how an altered work pattern prior to retirement would affect employee retirement benefits. It was determined that the benefit that results from a WRS money purchase calculation (defined contribution) is not significantly altered by a gradual shift in employment at the end of a working career. This is because the value of the money purchase benefit is determined more by compounded investment earnings over the career of the employee then the contributions on income in the years immediately before retirement. Therefore, a bridge job will have a minimal affect on employees who receive a retirement benefit that is based on a money purchase calculation.

For employees whose benefit is based on the formula calculation (defined benefit), a bridge job that lowers annual income will have a potentially significant negative effect on the resulting annuity. As previously discussed, this is because the earnings period used in the benefit calculation will likely not be the final years of employment, and therefore already eroded by inflation.

Examples

Several participant account scenarios were examined to determine how a bridge job could affect the defined benefit annuity (Exhibit C). Sample accounts were identified to determine the effect of a bridge position that is either half-time, or full-time with a 20% pay reduction, during a three-year period before beginning retirement. This exercise illustrated that employees who are phasing into retirement with a bridge job that reduces annual earnings can expect to reduce the lifetime value of their WRS annuity when compared to the benefit that they would have received if career employment continued until retirement. The following example illustrates this finding.

TABLE A. - A participant has 33 years of creditable service at age 60 and accepts a bridge job to last a period of three years. Retirement will then occur at age 63. The average of the three highest years of earnings at age 63 after either bridge job is $33,000 (for years of earnings at age 57, 58 and 59); if career employment continued, the average earnings would be expected to increase to $36,000 assuming a 3% annual increase (for years of earnings at age 60, 61 and 62)

Annuity at 63…	**Monthly Annuity**	**Life-time Value[10]**
…with no bridge job and career employment continues	$1,868	$727,464
…after full-time bridge job with a 20% pay reduction	$1,709	$665,544
…after half-time bridge job	$1,643	$639,841

In addition to the effect that a bridge job has on the potential value of the career benefit, in some cases the employee is actually better off financially to retire before transitional employment. This is especially true if an employee has already met the minimum requirements for an unreduced WRS formula benefit[11]. Each year, WRS retirees receive an annual dividend adjustment based on the earnings of the trust. This increases the monthly benefit amount and

[10] Lifetime value assumes death at age 85 with 3% annual dividend adjustments.
[11] An unreduced benefit is attained after minimum age and creditable service requirements are met. For employees in the general category, this is age 57 with 30 years of service.

may actually have a greater impact on the value of the annuity than the additional service that is credited during a bridge job.

For example, in the scenario illustrated in Table A, if we assume the employee retired at age 60, the monthly benefit would begin at $1,577. By age 63, after three years of annual dividend adjustments, the benefit increases to $1,724, which is greater than the benefit calculated at 63 that includes the additional service credits from either bridge job scenario. In addition, because the employee retired three years earlier and has received monthly payments during this period, the lifetime value of the benefit that begins at age 60 would increase to $729,578.

The above example demonstrates that the current structure of the WRS encourages employees who are considering a bridge job to first retire and then find alternate employment, either as a rehired annuitant or more likely with a non-WRS employer. As will be discussed in Chapter Four, annuitants that are rehired by the state of Wisconsin are not eligible for ancillary benefits, such as employer paid health insurance, creating an incentive to seek employment with a private employer that offers such benefits. This is detrimental to both the employee who may prefer the opportunities available by his prior employer, as well as the employer who loses the experienced and skilled employee and must seek and train a replacement.

Deferred Retirement Option Plan / DROP

One approach that is gaining in popularity in the pubic retirement plan arena is a deferred retirement option plan, or DROP. A DROP is considered a type of distribution option offered in a defined benefit plan. An employer often establishes this as an incentive to retain employees beyond retirement age. This study has identified that a DROP can also help protect the value of the benefit for employees who choose a transitional retirement approach.

Although there is no standard structure, the typical design of a DROP allows an employee who is eligible for a benefit to lock in its value but delay receipt of the annuity payments (and taxation on the payments) until a later specified retirement date. During the DROP period, the monthly annuity payments are credited to a separate participant account, but no additional service or contribution credits are applied to the original retirement account based on the continuing employment. When the employee ultimately retires (as previously specified), he or she receives the locked-in benefit plus the accumulated value of the DROP account. This balance can be paid to the employee either as a lump sum distribution or as a separate monthly annuity to be added to the previously established benefit. [An overview of the typical features of a DROP can be found in Exhibit D.]

Examples

Several participant account scenarios were examined to determine how a DROP could protect the value of an employee’s benefit [Exhibit C]. Assumptions were made that the amount deposited into the DROP would be credited with an assumed interest rate of 8% annually and the monthly benefit amount established at the beginning of the DROP would receive an annual dividend increase of 3%. The DROP balance on the final retirement date is calculated as a money purchase (defined contribution) benefit and added to the previously established monthly annuity.

Based on the analysis of the sample accounts, this approach can help protect and sometimes enhance the value of the WRS benefit for employees who chose a bridge job to phase into retirement. A DROP appears to protect the value of participants' benefits if they have not earned an unreduced benefit, when compared to the career benefit expectations if a bridge job was not chosen. For those who have reached an unreduced formula benefit level at the time the bridge position begins (maximum age and service), the DROP will actually enhance their benefit based on the assumptions used in this example. This is illustrated in the following tables. Table B depicts an employee who has not yet earned an **unreduced benefit** and Table C shows someone who has reached the minimum age and service requirements and is eligible for a benefit that is not **actuarially reduced**.

TABLE B.

A participant has 21 years of creditable service at age 55 and elects a DROP option. The participant will retire at age 58, at the termination of the bridge position. The formula benefit that is locked in at the beginning of the DROP is a monthly annuity of $796. This amount is deposited into the DROP account until the full retirement begins at age 58. The benefit at 58 is adjusted to add the value of the DROP as a straight life annuity.

Annuity at 58 after DROP…	**Monthly Annuity**	**Life-time Value**
…includes the $796 monthly annuity with annual 3% dividend adjustments to age 58 plus the $33,191 DROP balance calculated as a monthly annuity	$1,071	$551,748
Compared to transitional employment without a DROP and the annuity begins at 58…		
…after full-time bridge job with a 20% pay reduction	$1,064	$548,142
…after part-time (50%) bridge job	$ 984	$506,928
Compared to benefit if career employment continued until age 58…	$1,163	$599,144

TABLE C.

A participant has 33 years of creditable service at age 60 and elects a DROP option. The participant will retire at age 63, at the termination of the bridge position. The formula benefit that is locked in at the beginning of the DROP is a monthly annuity of $1,577. This amount is deposited into the DROP account until the full retirement begins at age 63. The benefit at 63 is adjusted to add the value of the DROP as a straight life annuity.

Annuity at 63 after DROP…	**Monthly Annuity**	**Life-time Value**
…includes the $1,577 monthly annuity with annual 3% dividend adjustments to age 63 plus the $65,758 DROP balance calculated as a monthly annuity amount	$2,168	$844,294
Compared to transitional employment without a DROP and the annuity begins at 63…		
…after full-time bridge job with a 20% pay reduction	$1,709	$665,544
…after part-time (50%) bridge job	$1,643	$639,841
Compared to benefit if career employment continued until age 63…	$1,868	$727,464

An actuarial analysis of the expected effect of a DROP option on the WRS current structure is needed to determine the cost impact to the WRS trust. If cost neutrality is determined to be an issue, there are various methods that could be used to reduce or eliminate the impact, such as:

- Limit the interest credited to the balance held in the DROP account.
- Reduce or eliminate the annual dividend adjustment to the payment during the DROP period.
- Reduce the employee's initial annuity payment that is calculated at the beginning of the DROP.

The following highlights advantages and disadvantages of a DROP

Advantages	***Disadvantages***
• Because an employee would not actually receive an income from the WRS benefit at the same time earnings are received from continued employment, there is less likelihood that this situation would be perceived as "double dipping".	• Because the benefit is locked in at the beginning of the DROP and no future earnings are considered in the benefit calculation, an employee will be negatively affected if earnings increase during the final employment years.
• The employee continues to participate in all ancillary benefits, such as employer paid health insurance and sick leave programs, during a transitional employment period.	• The employee gives up any right to benefit enhancements that may be initiated after the value of the benefit has been calculated but while still employed during the DROP period.
• The employer retains the skilled employee and the employee continues to receive a salary during a bridge job while at the same time the value of the annuity benefit accumulates in a DROP account.	• Administration and communication of DROP features can be difficult and/or costly.

DB/DC Conversion

A second alternative that was examined to protect the value of an employee's WRS benefit during a transitional retirement period is an approach that the study refers to as a DB/DC conversion. This option allows employees to convert the present value of their WRS account at the time the bridge job begins from a defined benefit (DB) to a defined contribution (DC) value. This would only apply to employees whose WRS formula benefit is greater than the money purchase amount when transitional employment is initiated.

Here's how it could work:

- *When a bridge position is accepted, the WRS formula benefit (DB) earned to-date would be calculated based on current years of service and three high years of earnings.*
- *An age reduction factor is then applied to the benefit's value based on the employee's current age.*
- *If the present value of this benefit is greater than the money purchase value (DC) of the participant's current account, the account is adjusted to reflect the higher formula benefit value (DB).*
- *During the bridge period, the adjusted account balance is credited with contributions and earnings in the same manner as all other active accounts.*
- *When termination occurs at the end of the bridge job, the employee receives a money purchase benefit (DC) based on the value of the WRS account.*

Examples

Several participant account scenarios were examined to determine how a DC/DB conversion would affect an employee's benefit when a bridge job has altered the normal career earnings [Exhibit C]. These examples show that this approach will protect the value of the benefit that has been earned during career employment and provide a more equitable benefit based on the earlier earnings for those that have not yet reached an unreduced benefit level. For those that have already earned an unreduced benefit, however, the DB/DC conversion goes beyond protecting the benefit and instead adds considerable value.

This is illustrated in the following tables. Table D depicts an employee who has not yet earned an unreduced benefit and Table E shows someone who has reached the minimum age and service requirements to be eligible for a benefit that is not actuarially reduced.

TABLE D.
A participant has 21 years of creditable service at age 55 and elects the DB/DC conversion before beginning a bridge job. The participant will retire at age 58, at the termination of the bridge position. The formula benefit is calculated at 55 based on current earnings and service, then converted to a money purchase value and applied to the participant account. The WRS account continues to be credited with contributions and earnings during the bridge position. The final benefit that results at retirement at age 58 is based on the money purchase calculation.

Annuity at 58 after the DB/DC conversion at 55…	**Monthly Annuity**
…after full-time bridge job with a 20% pay reduction	$1,115
…after part-time (50%) bridge job	$1,094
Compared to transitional employment with no conversion and annuity begins at 58…	
…after full-time bridge job with a 20% pay reduction	$1,064
…after part-time (50%) bridge job	$ 984
Compared to the expected benefit had career employment continued until age 58…	$1,163

TABLE E.
A participant has 33 years of creditable service at age 60 and elects the DB/DC conversion before beginning a bridge job. The participant will retire at age 63, at the termination of the bridge position. The formula benefit is calculated at 60 based on current earnings and service, then converted to a money purchase value and applied to the participant account. The WRS account continues to be credited with contributions and earnings during the bridge position. The final benefit that results at retirement at age 63 is based on the money purchase calculation.

Annuity at 63 after the DB/DC conversion at 60…	**Monthly Annuity**
…after full-time bridge job with a 20% pay reduction	$2,184
…after part-time (50%) bridge job	$2,160
Compared to transitional employment with no conversion and annuity begins at 63…	
…after full-time bridge job with a 20% pay reduction	$1,709
…after part-time (50%) bridge job	$1,643
Compared to the expected benefit had career employment continued until age 63…	$1,868

The impact to the WRS trust for implementing the DB/DC conversion would need to be examined through an actuarial analysis. However, most WRS participants who have reached an unreduced formula benefit level today would likely not benefit from a DB/DC conversion. This is because these participants have been earning the **effective rate interest** on their WRS account during their career employment, and their account value at the time a transitional employment begins will likely exceed the defined benefit formula value. Therefore, participants who would most benefit from this approach are those who currently receive the statutorily defined annual interest rate of 5% on their WRS account.

If cost neutrality is determined to be an issue, there are various ways that the DB/DC conversion could be structured to minimize the cost of this benefit feature, such as the following.

- Limit eligibility to employees who meet certain criteria (e.g., certain age and service requirements to only apply to those that have not yet attained an unreduced benefit).
- Apply less than 100% of the value of the DB conversion to the participant account.
- Require additional employee or employer contributions during the bridge employment.

The following highlights advantages and disadvantages of a DC/DB conversion

Advantages	***Disadvantages***
• *As with a DROP, this approach would not be perceived as "double dipping" and the employee would continue to receive ancillary benefits during transitional employment.*	• *Increases to annual income as well as any formula benefit enhancements enacted after the DB/DC conversion will not apply to the final benefit.*
• *The value of the benefit that has accrued prior to the bridge job is not reduced as a result of transitional employment.*	• *The administration of this option may be costly and difficult.*
• *The employer retains the skilled, experienced employee during a transitional retirement period.*	• *Communicating this option to employees may be difficult.*

Federal Law Issues

There is no specific reference to either the DROP or the DC/DB conversion approach in regulating federal tax laws. However, there are many public systems that have added a DROP and received favorable comments from the Internal Revenue Service on the structure of this plan feature as a distribution option under Section 401(a) of the IRC. The DC/DB conversion, however, is an approach that has been contemplated based on discussions with internal Department staff and it appears this initiative would be unique to the Wisconsin Retirement System.

The following federal tax laws issues need to be addressed in the design of either of these features.

- <u>Age Discrimination in Employment Act (ADEA)</u> - any new plan feature would need to be designed to ensure it does not discriminate against older workers. For instance, a feature that limited participation based only on age (e.g., eligibility limited to earliest age for retirement until normal retirement age) may raise ADEA issues.

- <u>Contribution limits</u> - annual additions to the WRS that apply to the money purchase benefit (DC) are subject to IRC Section 415(c) limits. The design of either alternative may be problematic as it relates to the annual contribution limits.

- "Definitely determinable benefit" rule - defined benefit plans are subject to the IRC 401(a) definitely determinable benefit rule that means benefit calculations must be established in the plan and there can be no employer discretion in setting benefit payments. Because of the hybrid nature of the WRS, this requirement must also be examined as it relates to the DROP and potentially to the DB/DC conversion.

- Distribution rules - qualified plans have specific requirements (e.g., minimum distribution requirements, qualified domestic relation orders) that must be met. Both the administrative structure and the communication of the DROP and the DB/DC conversion must address certain issues relating to distribution rules.

Study conclusions…
for protecting the benefit value during transitional employment

Although this study concentrated on a DROP and a DB/DC conversion, there were several other alternatives examined including an approach to index a specified earnings period upon which the benefit would be based, while employed in a bridge job. This preliminary review, however, has shown that the two identified options appear to best meet the objective of protecting the value of an employee's accrued benefit during a transitional retirement period. Many issues such as the cost impact to the system, administrative feasibility and compliance with regulating federal tax laws need further examination before more definitive conclusions can be reached as to which approach, or perhaps combination of the two alternatives, would be a better fit in the WRS structure.

IMPROVING OPPORTUNITIES FOR RETURNING TO WORK AFTER RETIREMENT

More flexibility to return to work offers participants additional transitional retirement opportunities.

Another barrier to transitional retirement within the WRS structure is the set of restrictions imposed on an employee's ability to return to work after beginning a retirement benefit. Currently, Wisconsin statutes governing the WRS require that employees remain terminated from employment for a period of at least 30 days to be eligible to receive a benefit. They are unable to return to work with their current employer or any other public employer covered under the WRS during this period, or their retirement benefit is canceled and their account reestablished. This requirement also prohibits an employee from having an agreement with a WRS employer, before termination of employment, to return to work after the 30-day period has elapsed.

In addition to the mandatory break in service, a returning retiree is no longer eligible for retirement coverage during the new employment period unless the retiree elects to cancel the annuity, even if this position would be covered if held by a non-annuitant. Most rehired annuitants also are restricted as to the benefits that they receive from the new employment. Employer paid benefits, such as health, life and disability insurance, are normally not provided to a rehired annuitant[12]. These barriers restrict the ability of WRS participants to phase into retirement and often encourage retirees to seek employment in the private sector.

The study identified several potential changes to the WRS structure to provide more flexibility to employees seeking a transitional retirement approach as follows:

- Remove the 30-day break in service restriction for participants who have attained normal retirement age and allow them to begin a retirement benefit at the same time a bridge job begins.
- Because of the multi-employer structure, allow participants to initiate work with a different WRS employer immediately at retirement without a minimum break in service.
- Provide employer paid ancillary benefits (e.g., health insurance) to annuitants that are hired by the state of Wisconsin, without requiring a termination of the retirement benefit.
- Allow a second, separate WRS participant account to be established, based on the bridge employment.
- Create a separate retirement plan (such as under Section 457) to allow pre-tax contributions and potentially an employer match (to the 401(a) plan) for the rehired annuitant to enhance the retirement benefit at the conclusion of a bridge position.

[12] Rehired annuitants employed by the State are not eligible for employer paid insurance benefits (health, life, disability) unless the annuity is stopped; some local government and school districts may provide certain ancillary benefits outside of the WRS benefit structure.

This section of the report describes the above options and identifies certain advantages and disadvantages of each.

<u>Background</u>

The WRS plan design and federal and state laws impose many roadblocks that discourage retirees from seeking employment with their current employer or any other public employer that is a member of the WRS. This is detrimental to both the employee who might prefer to resume employment with the current employer, but in a modified position, as well as the employer who loses the trained, skilled worker.

Wisconsin statutes appear more restrictive than required by federal tax laws governing qualified plans in regard to the WRS provisions on returning to work after retirement. Under current state laws, there are no provisions that would allow an in-service withdrawal from the WRS although the Internal Revenue Code (IRC) allows qualified defined benefit plans to permit distributions to begin without a termination of service once an employee has reached the plan's designated normal retirement age. The IRC is less than clear, however, as to what age the retirement system can actually use as this benchmark, or if (or how) this provision would apply to a hybrid retirement plan, such as the WRS.

Currently, the restrictions on in-service withdrawals apply whether the retiree is returning to employment with the same employer or any other public employer that is part of the WRS. Because the WRS is a multi-employer system, federal tax laws indicate that these rules could be applied only on situations where employees are returning to work with the same employer. This would allow an employee to retire with one public employer and begin a retirement benefit, while at the same time begin employment with a different public employer to gradually shift into a full retirement.

In addition to return to work restrictions, one additional roadblock that retirees seeking reemployment opportunities face is that they are not eligible for the same employer paid benefits as other employees receive. If a retiree moves into private sector employment, some paid benefits, such as health insurance and employer contributions to a retirement plan [such as a 401(k) plan] will often be provided. Because the WRS does not allow an individual to both receive a retirement benefit and have an active contributory account, and employer paid health benefits are usually not available, the retiree who is returning to work is more likely to look at private sector employment opportunities first.

A retiree who returns to work can elect to cancel the annuity at anytime and again become a participant in the WRS and eligible for active employee benefits. However, as shown in other discussions within this report, this may have a negative effect on the retirement benefit when it is recalculated to reflect the continuing employment. Additionally, some need the additional income from the retirement benefit to supplement the earnings from the bridge employment.

The restrictions on returning to work for retirees are, in part, to comply with federal tax laws. However, another important factor is the public perception that receiving retirement benefits at the same time a government employee has income from employment is "double dipping". In some retirement systems, the perception may result from their mechanism for funding benefits (all assets held in one trust fund pool - both current employer contributions and annuity reserve assets). The employer contribution level to fund future benefits may be affected by the reduction of new employees as more older employees are retained (as re-hires) and any cost-of-living adjustments added to current annuity payments funded by contributions. With this approach, it may be difficult to assure that a rehired annuitant is not affecting the actuarial valuation for calculating funding levels.

In Wisconsin, however, three separate asset reserves are maintained (annuitants, employers and employees), and issues such as annual dividend adjustments to annuitants have no bearing on employer contribution levels. When an employee begins his WRS retirement benefit, the assets to fund this are moved into the separate annuity reserve. The annual dividend amount paid to annuitant accounts is based on the earnings of the WRS trust that are assigned to the assets in the annuity reserve. Therefore, although the perception of "double dipping" (simultaneously receiving retirement benefits and a paycheck) still exists for some, there actually is no material financial effect to employers relating to increased contributions for all employees as a result of a WRS annuitant receiving both current income and a retirement benefit.

Return-to-work restrictions

As discussed above, there may be several opportunities under existing federal regulations to remove barriers currently in place that limit a retiree's ability to return to work with a public employer. Although expert tax advice is needed before proposing amendments to Wisconsin law, adopting as much flexibility as allowed within IRC qualified plan requirements will enhance WRS participants' ability to phase into retirement. Changes such as the following should be further explored.

- *Allow in-service distributions at normal retirement age, and designate normal retirement age as the earliest age an employee can obtain a WRS retirement annuity, or alternatively, as the age of eligibility for an unreduced benefit.*

- *Apply break-in-service requirements to employment with the same employer, only. This will allow an employee to gradually shift into retirement by seeking employment with a different public employer at the same time that a retirement benefit begins from the career employment.*

Both of the above options provide WRS participants with additional opportunities for phasing into retirement. However, the major obstacle that a retiree returning to a public employer faces is the lack of employer paid benefits. Currently, the only way to receive active employee benefits, such as continuing retirement coverage and employer paid health insurance, is if the retiree stops the annuity and the account is reestablished[13].

Worker shortages being experienced in the state of Wisconsin have caused some public employers to begin examining the feasibility of providing employer paid health insurance to annuitants who return to work. Because the rehired annuitant has the option to cancel his or

[13] Because local governments and school districts often provide benefits to employees and rehired annuitants outside the WRS benefit structure, the discussion on ancillary benefits in this report pertains to state and university employees only. Restrictions on continued retirement coverage as an annuitant apply to all WRS participants.

her annuity at any time to become a participating employee (and eligible for employee benefits including employer paid retirement contributions), the employer normally must budget for these employees as if they will receive full benefits.

Although employers do experience cost savings when rehired annuitants choose to continue to receive their WRS benefit, the savings cannot be guaranteed when the individual is initially hired or for the duration of the transitional employment. Therefore, while providing employer paid health insurance to rehired annuitants could be a significant enhancement for those transitioning into retirement, it may not have a tremendous cost impact on the employer's annual budget.

If the employer cost of health benefits is a factor, consideration could be given to the establishment of a separate, stand alone health plan for this group of employees as an additional alternative. This plan could provide reduced benefits or a larger portion of the premium assigned to the rehired annuitant.

Design flexibility to address transitional retirement needs should also be considered in the Wisconsin sick leave conversion program (for state and university employees). As discussed in Chapter One of this report, this program provides a means to fund retiree health insurance premiums. An employee's accumulated sick leave balance (plus any employer match the employee is entitled to) is multiplied by the final hourly rate of pay to determine the balance available to pay premiums during retirement.

An altered employment pattern in the years prior to retirement that reduces the final hourly rate of pay can significantly reduce the value of the sick leave conversion account. Therefore, modifying the method of calculating the balance in this account should be considered. One method identified to protect the value of the participant's account during a bridge job is to use the highest hourly rate within the last one to five years before retirement, instead of the final hourly rate of pay, to calculate the value of the sick leave conversion account balance.

Additional flexibility that has been discussed and is worth further consideration to improve the accumulated sick leave conversion account benefit for those that choose a bridge job, either before or after retirement is:

- Annually index the sick leave account balance after retirement, such as to the consumer price index (CPI) or to the medical CPI.

- Allow employees to pay a portion of the health insurance premium (e.g., 50% instead of 100%) with the remaining cost being paid out of pocket.

- Provide additional flexibility to escrow the sick leave account balance if termination of employment occurs before an employee reaches the earliest WRS retirement age.

Continuing retirement coverage for rehired annuitants

The study recognized that establishing a second WRS retirement account for rehired annuitants based on the new employment period could provide an easy approach to address transitional retirement issues. If the employment is in a position that would otherwise be eligible for participation in the WRS, the retiree could again become a participant (and eligible for all other active employee benefits) with employer and employee contributions being paid to the WRS based on the new employment. When the participant again terminated employment, at the end of the bridge position, the accumulated value of the second account would be paid as a separate benefit to enhance future retirement income.

Because employers would be required to make contributions for all employees, including rehired annuitants who are in a position that would otherwise be eligible for WRS coverage, there would be no cost impact to the trust. However, employers would not experience cost savings by employing rehired annuitants who might otherwise choose not to reestablish their WRS account.

As an alternative to creating a second retirement account in the WRS for rehired annuitants, another approach that has been identified is to establish a separate retirement plan for these individuals that would be structured similar to a Section 457 match plan[14]. Retirees would continue to be eligible for WRS active participation by stopping their annuity. However, if they chose employment as a rehired annuitant, the second retirement plan would provide additional benefits when the transitional employment period ended.

This second plan would be structured to allow the rehired annuitant to make voluntary pre-tax contributions to a Section 457 plan, such as the Wisconsin Deferred Compensation Program. The employer would then provide a match of this amount, up to a specified annual limit (e.g., $1,200) as an **employer additional contribution** to the WRS. Because the match would be made to the 401(a) plan, it would not affect the annual maximum contribution allowed to the Section 457 plan.

Considering the rehired annuitant is receiving two incomes (i.e., retirement annuity and bridge job earnings) these individuals would likely see this as a very attractive benefit for sheltering a portion of income from federal and state taxes. The annual deferral limit to a Section 457 plan currently is 25% of gross earnings up to $8,500 (for 2001). However, federal legislation has been proposed[15] that would remove the 25% of compensation limit. This would allow the annuitant to shelter up to 100% of the earnings from the bridge job from income taxes, up to the Section 457 maximum dollar limit, until the account balance would be distributed to them, presumably when full retirement begins.

This approach would have no cost impact on the WRS trust and there could be considerable flexibility in establishing the amount of the employer matching contributions. Although a review

[14] Section 457 match plans are typically established to encourage participation in this deferred compensation arrangement. The government employer will make a contribution to a separate 401(a) defined contribution plan based on the voluntary employee deferrals to the 457 plan. The employer match is limited to a specified annual amount (e.g., up to $600 per year).

[15] Pension legislation has been introduced several times (most recognized version being the Portman/Cardin bill) that has included several amendments to Section 457 such as removing the 25% of compensation deferral limit.

of the regulating federal tax requirements would need to be completed, it might be possible to establish the matching contribution levels on a case by case basis, instead of universally to all rehired annuitants. This would provide the employer additional options in attracting or retaining skilled workers who are looking for a transitional approach to retirement.

Study Conclusions…
for improving opportunities for returning to work after retirement

There are several options that should be considered to improve WRS participants' opportunities to return to work after retirement. The options the study determined to be most worthy of further consideration include:

- Remove the 30-day break in service restriction for employees who have attained normal retirement age as well as for those who are moving from one WRS employer to another to accept a bridge position.

- Change the current regulations regarding employer paid benefits to allow employer paid health insurance to be obtained for rehired annuitants.

- Apply a different method of calculating the accumulated sick leave conversion account balance to protect the value of this benefit for those transitioning into retirement.

- Allow a second WRS account to be established for rehired annuitants or create a separate optional plan to enhance the final benefit after a bridge job.

CREATING A SUPPLEMENTAL INCOME STREAM FOR TRANSITIONAL RETIREMENT

Supplemental income may be obtained through primary or supplemental retirement programs.

Not all employees are financially able to phase into retirement. For some, the reduced earnings that would be experienced in a bridge job (either because of lower hourly wages or reduced hours) is not sufficient to support their current income needs. These individuals may have no choice but to continue working in their career position, beyond the time they feel mentally or physically able to handle the job, or retire early and then return to employment as an annuitant.

Neither of the above scenarios may be advantageous to either the employee or the employer. For the employee, continuing to work in the current position may be problematic while beginning a full retirement benefit may provide more income than is needed during a bridge employment. The employer may prefer to retain the skilled employee, but perhaps in a modified or reduced position.

To address this transitional retirement issue, the last objective of the Wisconsin study is to identify potential opportunities that could be created within the WRS benefit structure to provide a supplemental income stream during a bridge job. The study examined options that could be created from the primary retirement benefit available through the WRS as well as supplemental retirement plans, such as the Wisconsin Deferred Compensation Program (WDC) regulated by Section 457 of the Internal Revenue Code.

Background

As identified in Chapter Four, current Wisconsin Statues prohibit in-service withdrawals from the WRS regardless of the employee's age. The Internal Revenue Code (IRC) appears to allow distributions from a qualified defined benefit plan to begin without a termination of service once an employee has reached normal retirement age. Adopting the earliest age an employee can obtain a WRS retirement annuity as the plan's normal retirement age would allow the system more flexibility to design distribution options that can offer a supplemental income stream during a bridge job. However, before this can be proposed as an amendment to Wisconsin Statutes, expert tax advice is needed to better understand the requirements of the IRC as it applies to in-service distributions at normal retirement age.

In the Wisconsin Deferred Compensation Program, unforeseen financial hardship withdrawals and de minimis distributions of inactive accounts with balances that are $5,000 or less are the only provisions in IRC that would allow the Section 457 plan to permit in-service distributions. The one potential exception is to amend the plan to allow loan provisions.

Supplemental Plan Options

Employees who participate in a deferred compensation arrangement such as a Section 457 or 403(b) plan are currently able to use these assets to supplement income during a bridge job. To be eligible for a distribution from these plans, however, the employee must terminate from service before beginning the second employment period.

The federal tax law restrictions governing these plans for returning to work appear to be less stringent than those that apply to a qualified plan. A termination of one-day, as long as deferrals are not reinitiated with the new employment, may be sufficient to begin a distribution. There is one significant drawback in regard to early distributions from a 403(b) plan, however, as distributions that begin before age 59½ must be structured to be paid over the employee's lifetime to avoid a 10% early distribution tax penalty. Distributions from Section 457 plans are not subject to this penalty.

A loan feature in the supplemental plan may offer an employee another alternative to obtain an income stream during a bridge job without termination of employment. This is often a feature available in Section 403(b) and 401(k) plans and, with the enaction of the 1996 Small Business Job Protection Act (SBJPA), this now may be possible in a Section 457 plan. The SBJPA amended Section 457(b) to require that plan assets be held in trust for the exclusive benefit of its participants. Because of the trust language, there has been some controversy as to if these plans can now offer loans to participants in the same manner that is allowed for plans regulated by Section 401(k) [16]. No advice has yet been given or regulations issued from the United States Department of Treasury or the Internal Revenue Service on the issue of loans in Section 457 plans.

The enhanced feature of a loan provision may offer additional opportunities to participants of the Wisconsin Deferred Compensation Program (WDC) for providing a source of income during a bridge job. The WDC is a Section 457 plan that is available to all state and university employees as well as employees of local governments and school districts that have elected participation in this program. Adopting a loan provision in this plan would offer its participants the ability to establish an income stream from their accumulated assets.

Although there are many differing opinions regarding the feasibility of offering loans in a retirement savings plan, one significant advantage is the flexibility it can offer participants as they transition into retirement. A loan can be initiated to cover the difference between the earnings from the career position and the bridge job, plus the amount necessary to repay the loan until retirement begins. Loan repayments, including interest, are deposited back into the participant account and will again be available to provide retirement income when termination occurs. At retirement, the outstanding loan balance is deducted from the assets (and subject to income tax) before the remaining account is distributed to the participant.

The disadvantage of this approach is the loss of potential investment earnings that the participant experiences by taking a loan from the assets in this retirement account. Although

[16] The 1996 SBJPA Conference Committee report provided reference to the ability of Section 457 plans to allow loans under the trust provisions.

the loan repayments are placed back into the employee's account and include an interest assessment, this typically is considerably less than the earnings that would be anticipated through a well-diversified investment plan. The loss of investment opportunity on these assets, as well as the value of compound interest, can greatly reduce the retirement income that is available from the supplemental retirement savings plan.

New WRS Distribution Option

Not all employees participate in a supplemental retirement plan and they are counting on the primary WRS retirement benefit to meet all their future income needs. For this reason, the study explored how the WRS can offer a supplemental income stream to those who choose a bridge job to transition into retirement. For purposes of this discussion, the option that has been explored contemplates a full termination followed by a reemployment into a bridge job after a mandatory break-in-service, or a bridge job with a non-WRS employer.

The study concluded that the WRS could meet this employee need through the establishment of a new distribution option structured to provide supplemental income while the employee is in a bridge job. This is how it would work. At the time of termination and initiation of the retirement benefit, the employee would elect the percentage of the benefit that he or she would like to receive for a specified number of years (e.g., 25% for three years). After the designated period, the full benefit would then be recalculated and "pop up" to the full amount when the normal retirement begins, presumably at the end of a bridge job.

Examples

For illustration purposes, this new distribution type is referred to in this report as a "bridge benefit". Although there could be many variations of this option, the study explored two specific scenarios as follows:

- *A 25% bridge benefit - assumes that 1/4 of the account will be used to pay the bridge benefit. The employee would receive an annual dividend adjustment on the bridge benefit amount. The remaining 3/4 balance in the account would then continue to earn interest until full retirement.*

- *A 50% bridge benefit assumes that 1/2 of the account will be used to pay the bridge benefit, an annual dividend adjustment would apply to the bridge amount and the remaining 1/2 account balance earns interest until full retirement.*

Several examples were examined to identify how the bridge benefit could best meet participant's needs (Exhibit C). The study only considered situations where the employee is eligible for a retirement benefit at the time a bridge job begins.

Two separate conditions were examined. The first assumed no additional WRS credit is given for any employment during the bridge job, since rehired annuitants do not currently participate in the WRS[17]. The second explored how the final benefit would be affected if an employee's additional earnings and service with a participating WRS employer during a bridge job were

[17] Unless they stop their annuity and their WRS account is reestablished; at which point they again become an active participant.

taken into account when calculating the pop-up amount. The final pop-up benefit amount is calculated as a money purchase benefit based on the balance remaining in the WRS account at the end of the bridge period.

This analysis showed that a WRS distribution option could be designed to provide employees a supplemental income stream during a bridge job. Additionally, the affect on the income a retiree receives from the WRS at final retirement for the three-year bridge payments is minimized if the individual receives continuing credits to the WRS while employed in a bridge job. The following example demonstrates this finding.

TABLE F. - *A participant with 31 years of service at age 60 and intends to work in a bridge job for three years. The WRS formula annuity at age 60 would pay $1,164 per month. The following illustrates a 25% and 50% bridge benefit plus the pop-up value at retirement, after three years: 1) considering no additional credits to the WRS, and 2) how this would be affected should the bridge position receive additional service credit. [For comparison purposes, without a bridge benefit and retiring at age 60, the WRS benefit plus annual dividends would produce a $1,466 monthly payment at age 63.]*

Situation	25% bridge benefit	50% bridge benefit
Bridge Benefit	$291	$582
1) Pop-up Benefit – at age 63 **No WRS credit for bridge job**	$1,498	$1,423
2) Pop-up Benefit – at age 63 **With WRS credit for bridge job**[18]	$1,542	$1,452

As an alternative to the money purchase calculation for determining the final pop-up benefit, this feature could be designed similar to a DROP account (as discussed in Chapter Three) as follows:

- The portion of the initial calculated benefit that is not paid to the participant (e.g., 50% or 75%) is recorded into a separate account (set up similar to a DROP) during the bridge period.
- Annual interest would be applied to this balance until the bridge period ends.
- This balance would be converted to a monthly benefit amount to add to the original bridge benefit.

There can be considerable flexibility within the actual design of the bridge benefit. For instance, this could be offered as an optional feature on any of the current annuity options. Also, participants could be allowed to designate the percentage of the full benefit that they want to receive as the bridge annuity, with certain minimum and maximum limits imposed (e.g., not less than 25% nor more than 75% of full benefit amount). The number of years that the participant would receive the bridge benefit could also be flexible with a minimum and maximum period established (e.g., one to five years).

An actuarial analysis of this benefit feature is needed to determine the overall impact this might have on the WRS trust. There are, however, several possible alternatives for structuring the

[18] Earnings assumptions during the bridge job are: for 25% bridge benefit - annual earnings reduced by 25% the first year, then increased by 3% in subsequent years; 50% bridge benefit - annual earnings reduced by 50% the first year, then increased by 3% for each subsequent year

bridge benefit to minimize cost or possibly establish this as a cost neutral enhancement to the system, as noted below.

- Calculate the pop-up annuity only as a formula benefit.
- Reduce or cap the earnings that are applied to the balance that remains in the trust during the bridge benefit.
- Restrict the type of annuity options upon which this benefit can be applied.

The following highlights advantages and disadvantages of a bridge benefit.

Advantages	***Disadvantages/Issues***
• *Employees are not forced into prematurely beginning their WRS benefit in order to supplement income during a bridge job.*	• *Compliance with minimum required distribution rules could be a concern for employees beginning a benefit beyond a certain age (e.g., age 70).*
• *Provides employees who cannot afford reduced earnings from a bridge job an opportunity to phase into retirement.*	• *If not structured carefully, could potentially negatively affect an employee's income once full retirement begins.*
• *Employers are able to retain skilled, experienced employees who wish to phase into retirement.*	• *Communication and administration of this plan feature could be difficult and costly.*

Study Conclusions…
for providing supplemental income stream during a bridge job

Supplemental plans provide certain options to its participants for creating a supplemental income stream while phasing into retirement. A loan provision should be considered in the Wisconsin Deferred Compensation Program to provide additional flexibility to supplement pre-retirement income. Adding a bridge benefit, as defined in this report, to the WRS structure also offers employees an excellent opportunity to supplement income during transitional retirement employment.

WHAT'S NEXT FOR WISCONSIN

This report represents the beginning of efforts to identify how the WRS can change to meet the needs of its maturing employee population. What this report identifies is that there are a variety of options that can be considered, some simple and some complicated, to allow employees to adopt a more phased approach to retirement.

This report is the first step in the process to change the look of retirement planning for Wisconsin public employees.

The different proposals within this report are a starting point for further analysis and consideration. Some suggested features should be explored in tandem with other options. For instance, adopting in-service distributions at normal retirement age at the same time as installing a bridge benefit would provide a very attractive transitional retirement opportunity for many public employees.

Certain provisions will require additional review by a federal tax counsel to identify potential compliance issues with qualified plan requirements. Some features may be immediately explored to provide as much flexibility to WRS participants as possible under existing State and Federal laws, such as the determination of what is normal retirement age for the purpose of allowing in-service distributions.

This report will be forwarded to the Retirement Research Committee and the Joint Survey Committee on Retirement Systems, two legislative committees that are charged with the responsibility of analyzing potential changes to the WRS. The findings identified in this report may present opportunities for changes that can be further pursued in Wisconsin laws to better accommodate the changing retirement needs of public employees. An actuarial study of the different proposals will be necessary to identify the cost impact to the Wisconsin Retirement System trust and identify the various design alternatives that may reduce or eliminate any additional cost.

DEMOGRAPHICS

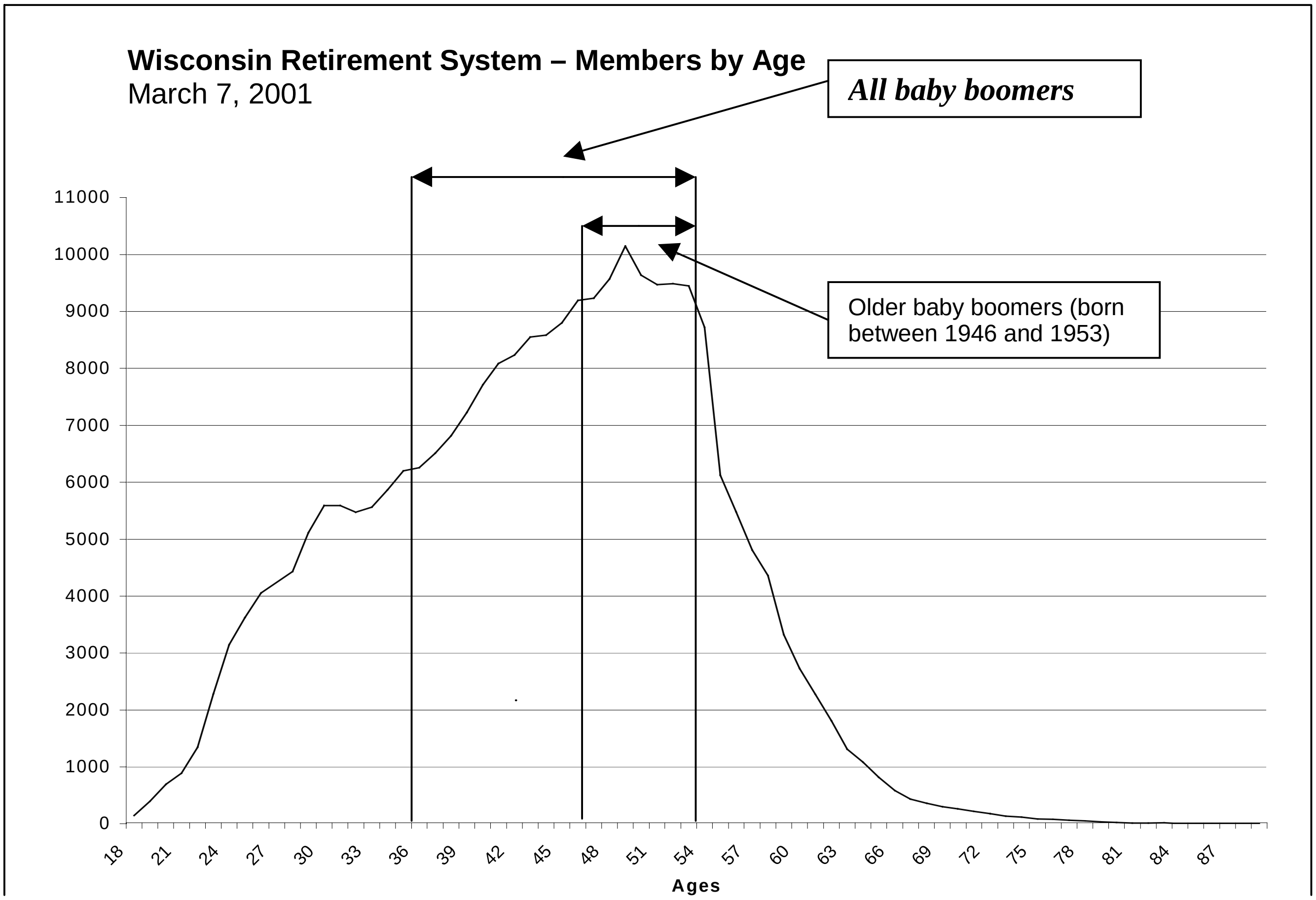
The baby-boom generation has had a significant impact on the labor force since their initial entry into the labor market. It is no surprise, then, that baby-boomers will also have a significant impact as they leave the labor force for retirement. The impact of older baby-boomer (those born between 1946 and 1953) retirements will be felt beginning as early as the year 2005. However, many believe the most dramatic impact will occur in the decade following 2008.

The severity of the impact of retiring baby-boomers will be compounded by the fact that the number of persons working, or looking for work, is decreasing. According to the U.S. Bureau of Labor Statistics (BLS), there has been a 3 percent decrease in the number of people working or looking for work between 1986 and 1996 as compared to the previous 10-year period.[19] Needless to say, as baby-boomers begin retiring, significant changes will take place in the labor force and labor shortages may appear. By the year 2018, nearly all baby-boomers will be of retirement age and the pool of younger workers will not be sufficient to replace all the retiring baby-boomers.[20]

The BLS estimates the average age of retirement throughout the United States somewhere between 61 and 62 years of age.[21] This estimate is based on private and public sector employees. However, if one looks specifically at the public sector, the timing of the impact of retiring baby-boomers will differ from that in the private sector. According to U.S. Department of Labor (DOL) statistics, two-thirds of state and local government pension plans allow members to retire at age 55 (or earlier depending on the employee's total years of service).[22] Thus, the impact of retiring baby-boomers in the public sector will be felt well before the impact in the private sector.

As an example, members in the Wisconsin Retirement System (WRS) may retire with an unreduced benefit at age 57 if the member has 30 years of service (age 53 with 25 years of service for protective category employees such as police and fire positions). And, members may be eligible to retire with a "reduced" benefit at age 55 (50 for protective category employees). Although the majority of members do not choose to retire at the earliest age possible, the average age of retirement within the retirement system is declining. According to Wisconsin Department of Employee Trust Fund statistics, the average age of retirement within the WRS in 2001 is 59.8 years as compared to an average of 62.1 years in 1987. As can be seen in the following graph, older baby-boomers within the WRS are fast approaching retirement age.

[19] Monthly Labor Review, Labor force 2006: slowing down and changing composition, November 1997.
[20] Monthly Labor Review, Gauging the labor force effects of retiring baby-boomers, July 2000.
[21] Bureau of Labor Statistics, unpublished tabulations from the Current Population Survey, 1999 annual averages.
[22] Monthly Labor Review, Gauging the labor force effects of retiring baby-boomers, July 2000.



As can be seen in the following table, baby-boomers make up the largest segment of active members within the Wisconsin Retirement System. In total, baby-boomers make up 61% of the active membership while those coming behind the baby-boomers, the Generation X population (those born between 1965 and 1979) make up 24% of the active membership. The remaining 13% are members born before 1946 or after 1979.

Wisconsin Retirement System Membership: Baby-Boom and Generation X Populations		
All Active Members	259,261	100%
Early Baby-Boomers	74,368	29 %
Late Baby-Boomers	84,721	32 %
Generation Xer's	62,471	24 %

Source: Wisconsin Department of Employee Trust Funds, March 2001

The State of Wisconsin as a whole, both private and public sectors, has some unique circumstances which may exacerbate the impact of baby-boomer retirements. For example, the lack of enough younger workers available to take the place of retiring baby-boomers is more pronounced in Wisconsin than it is on the national level[23] because:

- Wisconsin's birthrate after the baby-boomer period remained consistent with the U.S. birthrate until 1979 when Wisconsin's rate began decreasing while the U.S. rate began increasing;

[23] Wisconsin Department of Workforce Development, A Wisconsin Employers' Guide for Recruitment and Retention Survival in the Late 20^{th} and Early 21^{st} Century, March 1996.

- Many Midwestern States, including Wisconsin, did not receive the same level of immigrant influx as occurred in other States; and
- Wisconsin has suffered the loss of workers and the inability to attract new and/or maintain current employers due to Wisconsin's lower wages.

The bad news appears to be an upcoming labor shortage in Wisconsin. According to the Wisconsin Taxpayers Alliance, between the years 2000 and 2010, there will be 47,000 Wisconsinites turning 65 years of age and that number will increase to 67,000 between 2010 and 2016. Based on these numbers, which assumes an age of retirement at 65, Wisconsin will incur a severe labor shortage after 2010 when those exiting the labor force begin to outnumber those entering the labor force.[24] If, in fact, the national average age of retirement (e.g., 61 to 62), as estimated by the BLS, holds true in Wisconsin, then this labor shortage may begin 3 or 4 years earlier than projected by the Taxpayer Alliance.

The BLS projects that within the public sector, the worst labor shortages will occur in the teaching, public education administrator and public administrator/official occupations. The most dramatic impact, according the BLS, will be in the teaching occupation[25] because:

- Teachers historically retire earlier than other occupations, and
- There was a decrease in the number of new teacher hires in the 1980's and early 1990's that had the effect of raising the average age of teachers.

The following is an excerpt of the public sector occupations from a BLS chart depicting occupations with the highest percentage of workers aged 45 years and old, as of 1998:

Occupations In 1998 With The Highest Percentage Of Workers Aged 45 Years And Older

Occupations	**Total employed (in thousands)**	**Percent of employees 45 yrs & older**	**Median age**
All Employees	131,995	33.7%	39
Administrators/officials, public admin.	632	58.7%	47
Administrators, education and related	754	56.1%	47
Teachers, secondary schools	1,228	50.3%	45
Counselors, education/vocational	231	50.2%	45

Source: Monthly Labor Review, Gauging the labor force effects of retiring baby-boomers, July 2000

The good news appears to be the growing trend of retired workers returning to the labor force. In an analysis conducted by the American Association of Retired Persons (AARP), 8 out of every 10 baby-boomers will work in retirement, but not necessarily full-time or for the same employer from which they retired.[26] Likewise, the *2000 Retirement Confidence Survey* depicts similar results. Of the current workers surveyed, 67 percent of workers in all age groups indicated they intend to work in retirement and, of older baby-boomers, that percent increased to seventy-five.[27]

[24] Wisconsin Taxpayers Alliance, The Wisconsin Taxpayer – A monthly review of Wisconsin government, taxes and public finance, Vol. 68 No. 4, April 2000.
[25] Monthly Labor Review, Gauging the labor force effects of retiring baby-boomers, July 2000.
[26] American Association of Retired Persons, Baby Boomers Envision Their Retirement: An AARP Segmentation Analysis, February 1999.
[27] 2000 Retirement Confidence Survey, Co-sponsored by the Employee Benefit Research Institute, the American Savings Education Council, and Mathew Greenwald & Associates, Inc., May 2000.

The reasons that retirees return to work are varied. The DOL suggests that some retired workers will find it necessary to work in retirement[28] because of:

- Increasing health care costs;
- Inadequate retirement savings;
- The rising age of Social Security eligibility; and/or
- The trend away from defined benefit retirement plans (which provide monthly annuity payments) to lump-sum retirement plans.

However, in *The 2000 Retirement Confidence Survey* referenced above, the following are reasons for returning to work cited by current retirees (note: a respondent could select more than one reason):

Major Reasons for working in retirement cited by retirees:	
Enjoy work and want to stay involved	75%
To have money to buy extras	30%
To keep health insurance or other benefits	25%
To have money to make ends meet	21%
To try a different career	14%
To help support children or other household members	9%

Source: 2000 Retirement Confidence Survey, May 2000

These reasons cited by retirees for returning to work appear to suggest, from the majority of responses, that retirees return to work because they want to, not because they have to.

The *2000 Retirement Confidence Survey* also identified the following:

- Many workers are planning to retire early (36 percent of older baby-boomers and 31 percent of younger baby-boomers plan to retire prior to age 60).

- Amounts accumulated for retirement by workers as a whole are generally not adequate (a quarter of all workers have saved less than $10,000 for retirement).

- Many workers are planning for an unrealistically short retirement (half of men reaching age 62 can expect to be alive at 82 while half of women reaching age 65 can expect to be alive at 86, however. However, 18 percent expect that their retirement will last for 10 years or less and an additional 15 percent believe their retirement will last 11 to 19 years).

In conclusion, although a labor shortage is looming on the horizon for the decade between 2008 and 2018, there does appear to be some relief in sight. Although baby-boomers will retire at an earlier age than their predecessors did, they also plan to re-enter the labor force after retirement in large numbers. According to a report prepared for DOL by the Urban Institute, the retirement of baby boomers will have a significant impact on the demand for employment services of older workers.[29] The challenge for many employers will be how to retain and/or attract these highly skilled and trained older workers.

[28] Monthly Labor Review, Older workers in the 21st century; active and educated, a case study, June 1996.
[29] The Urban Institute, The Aging Baby Boom Implications for Employment and Training Programs, June 1997.

SURVEY OF PUBLIC RETIREMENT SYSTEMS

On February 13, 2001, a survey soliciting information on transitional retirement options was distributed via the National Council on Teacher Retirement (NCTR) to its membership. The purpose of the survey was to gather information on transitional retirement options available and/or currently under consideration within public pension systems around the country. The survey responses are detailed on the attached table and a summary of the results follows.

Of the 28 retirement systems that responded, six systems are single-employer plans and 22 are multi-employer plans. Twenty-two are defined benefit (DB) plans, one system is a defined contribution (DC) plan, two systems have both DB and DC plans, and three systems are hybrid plans. The average number of members is 159,001 with a high of 661,392 and a low of 1,850. The average amount of plan assets is $21.9 billion.

In total, 9 systems indicated some type of transitional option is in place:

- Four systems have restricted or limited return-to-work provisions.
- Three systems have a Deferred Retirement Option Plan (DROP).
- One system allows an employee to work part-time but receive service credits (and contributions) as if the employee is working full-time.
- One system has a return to work option that works similar to a DROP as well as an option that allows an employee to work part-time but receive service credits (and contributions) as if the employee is working full-time.

One of the systems above that currently has a return-to-work (with limited earnings) provision in place is currently considering a retroactive DROP and/or a partial lump sum payment at 30 years of service. Of the 19 systems that indicated no transitional retirement option:

- Three have legislation pending (partial lump sum distribution, allow distribution while continuing to work, return to work).
- Three indicate some type of transitional retirement option consideration is currently underway.
- Six plan to consider transitional retirement options within the next three years.
- Six have no plans for considering transitional retirement options.
- One did not respond to this question.

In summary, 32% of respondents (nine) indicated some type of transitional retirement option is currently available and 46% of respondents (13) indicated they have legislation pending, are currently considering options or will be considering options in the next three years.

TRANSITIONAL RETIREMENT SURVEY RESULTS

NAME OF SYSTEM	TOTAL MEMBERS	ASSETS (BILLIONS)	EMPLOYER PLAN TYPE		PLAN TYPE	TRANSITIONAL OPTIONS		OPTION TYPES		CONSIDERING TRANSITIONAL RETIREMENT OPTIONS?		COPY OF ETF STUDY?	
			SINGLE	MULTIPLE		YES	NO	DROP	OTHER	NO	YES - EXPLAIN	YES	NO
Alaska Teachers Retirement System	84,000	13.0		X	DB		X				Consideration of options underway	X	
Arkansas Teacher Retirement System	75,000	7.9		X	DB	X		X				X	
California State Teacher Retirement	661,392	112.6		X	DB	X			X1			X	
Connecticut Teachers Retirement System	75,000	12.0	X		DB		X				Will consider in near future	X	
Duluth Teachers' Retirement System	2,500	0.3		X	DB		X				Will consider in near future	X	
Georgia Teachers Retirement System	220,000	42.0	X		DB		X				Return-to-work legislation pending	X	
Idaho Public Employee Retirement System	94,000	7.0		X	Hybrid		X				Will consider in near future	X	
Illinois State Teachers' Retirement System	144,975	25.1		X	DB		X				Consideration of options ongoing	X	
Indiana Teachers' Retirement System	135,000	6.0		X	Hybrid		X			X			X
Kentucky Retirement System	220,000	13.0		X	DB		X			X			X
Louisiana Teachers Retirement System	140,172	12.7		X	DB2	X		X				X	
Michigan Public Employee Retirement System	400,000	40.1		X	DB	X			X3		Considering retro-active DROP or partial lump sum with 30 years service	X	
Minnesota Teachers Retirement Association	70,000	17.8		X	DB	X			X1&4			X	
Missouri Public School Retirement System	110,000	28.0		X	DB		X				Legislation pending to allow distribution & continuing working	X	
Montana Teachers' Retirement System	18,500	2.5		X	DC		X			X		X	
Nebraska Public Employees' Retirement System	85,000	5.5		X	DB/DC		X			X		X	
New Mexico Educational Retirement	63,000	7.8	X		DB		X				Consideration of options underway	X	
New Mexico Public Employees Retirement Association	74,786	8.1		X	DB5		X				Will consider in near future	X	

NAME OF SYSTEM	TOTAL MEMBERS	ASSETS (BILLIONS)	EMPLOYER PLAN TYPE		PLAN TYPE	TRANSITIONAL OPTIONS		OPTION TYPES		CONSIDERING TRANSITIONAL RETIREMENT OPTIONS?		COPY OF ETF STUDY?	
			SINGLE	MULTIPLE		YES	NO	DROP	OTHER	NO	YES - EXPLAIN	YES	NO
New York State Teachers Retirement System	230,000	85.0	X		DB		X					X	
North Carolina Teachers' and State Employees' Retirement System	285,784			X	DB	X			X6	X			
North Dakota Teachers Retirement System	16,000	1.4		X	DB		X				Will consider in near future		
Omaha School Employees' Retirement System	8,885	0.9	X		DB		X			X		X	
Pennsylvania Public School Employees' Retirement System	418,950	53.4		X	DB	X			X7	X		X	
Tennessee State Consolidated Retirement System	190,000	25.0		X	DB	X			X8			X	
Vermont State Teachers Retirement System	12,648	1.2		X	DB		X			X		X	
Virginia Retirement System	296,595	40.7		X	DB	X			X9		Legislation pending on partial lump- sum distribution	X	
West Virginia Consolidated Public Retirement System				X	DB/DC		X				Will consider in near future	X	
Wichita Employees' Retirement System	1,850	0.5	X		Hybrid	X		X				X	
Totals			*6*	*22*		*9*	*19*	*3*	*6*	*8*	*13*	*24*	*2*

Average # of Members = 159,001   Average Assets = $21.9 Billion

Option Types Key

1. Allows employee to reduce workload to part-time but receive credit as if working full-time.
2. Defined Benefit Plan with a DC option for higher education.
3. Return to work provision limited to 1/3 of average earnings prior to retirement.
4. Return to work provision that is similar to a DROP. If the retiree exceeds earnings limit, the reduced benefit goes into a savings account payable at age 65 or within one year of termination, whichever is later.
5. Also an optional 457 plan.
6. Return to work provision for retirees with member employers on a part-time/temporary basis with restriction on earnings.
7. Return to work provision for retirees during emergency situations for limited number of days.
8. Return to work provision for 100 days temporary annual employment and special needs employment after one year of retirement up to 85% salary.
9. Studied a DROP provision but decided against offering.

ACCOUNT ILLUSTRATIONS

Examples for Chapter 3 - Protecting Value of Retirement Benefits

TABLE AA. - Impact bridge job has on retirement benefit

A participant has 30 years of creditable service at age 58 and accepts a bridge job to last a period of three years. Retirement will then occur at age 61. The average of the three highest years of earnings at age 61 after either bridge job is $36,060 (for years of earnings at age 55, 56 and 57); if career employment continued, the average earnings would be expected to increase to $39,404 assuming a 3% annual increase (for years of earnings at age 58, 59 and 60)

Annuity at 61…	**Monthly Annuity**	**Life-time Value**[30]
…with no bridge job and career employment continues	$1,885	$824,709
…after full-time bridge job with a 20% pay reduction	$1,725	$754,707
…after half-time bridge job	$1,653	$723,206
If retired at age 58, monthly benefit would be $1,581 and at 61 with 3% annual dividend adjustments it would equal this amount	$1,728	$814,485

A participant has 31 years of creditable service at age 60 and accepts a bridge job to last a period of three years. Retirement will then occur at age 63. The average of the three highest years of earnings at age 63 after either bridge job is $25,737 (for years of earnings at age 57, 58 and 59); if career employment continued, the average earnings would be expected to increase to $28,145 assuming a 3% annual increase (for years of earnings at age 60, 61 and 62)

Annuity at 63…	**Monthly Annuity**	**Life-time Value**
…with no bridge job and career employment continues	$1,384	$538,977
…after full-time bridge job with a 20% pay reduction	$1,267	$493,414
…after half-time bridge job	$1,215	$473,163
If retired at age 60, monthly benefit would be $1,164 and at 63 with 3% annual dividend adjustments it would equal this amount	$1,272	$538,509

TABLE BB. - Benefit before DROP is subject to actuarial reduction

A participant has 22 years of creditable service at age 58 and elects a DROP option. The participant will retire at age 61, at the termination of the bridge position. The formula benefit that is locked in at the beginning of the DROP is a monthly annuity of $975. This amount is deposited into the DROP account until the full retirement begins at age 61. The benefit at 61 is adjusted to add the value of the DROP as a straight life annuity.

Annuity at 61 after DROP …	**Monthly Annuity**	**Life-time Value**
…includes the $975 monthly annuity with annual 3% dividend adjustments to age 61 plus the $40,671 DROP balance calculated as a monthly annuity	$1,327	$580,577
Compared to transitional employment without a DROP and the annuity begins at 61…		
…after full-time bridge job with a 20% pay reduction	$1,159	$507,075
…after part-time (50%) bridge job	$1,087	$475,575
Compared to benefit if career employment continued until age 61…	$1,260	$550,827

TABLE CC. - Benefit before DROP is not subject to actuarial reduction

A participant has 30 years of creditable service at age 58 and elects a DROP option. The participant will retire at age 61, at the termination of the bridge position. The formula benefit that is locked in at the beginning of the DROP is a monthly annuity of $1,581. This amount is deposited into the DROP account until the full retirement begins at age 61. The benefit at 61 is adjusted to add the value of the DROP as a straight life annuity.

Annuity at 61 after DROP…	**Monthly Annuity**	**Life-time Value**
…includes the $1,581 monthly annuity with annual 3% dividend adjustments to age 61 plus the $30,163 DROP balance calculated as a monthly annuity amount	$1,921	$840,459
Compared to transitional employment without a DROP and the annuity begins at 61…		
…after full-time bridge job with a 20% pay reduction	$1,725	$754,707
…after part-time (50%) bridge job	$1,653	$723,206
Compared to benefit if career employment continued until age 61…	$1,885	$824,709

[30] Lifetime value assumes death at age 85 with 3% annual dividend adjustments.

TABLE DD. Benefit at time of DB/DC conversion is subject to actuarial reduction

A participant has 22 years of creditable service at age 58 and elects the DB/DC conversion before beginning a bridge job. The participant will retire at age 61, at the termination of the bridge position. The formula benefit is calculated at 58 based on current earnings and service, then converted to a money purchase value and applied to the participant account. The WRS account continues to be credited with contributions and earnings during the bridge position. The final benefit that results at retirement at age 61 is based on the money purchase calculation.

Annuity at 61 after the DB/DC conversion at 58…	**Monthly Annuity**
…after full-time bridge job with a 20% pay reduction	$1,367
…after part-time (50%) bridge job	$1,345
Compared to transitional employment with no conversion and the annuity begins at 61…	
…after full-time bridge job with a 20% pay reduction	$1,159
…after part-time (50%) bridge job	$1,087
Compared to the expected benefit had career employment continued until age 61…	$1,260

TABLE EE. Benefit at time of DB/DC conversion is not subject to actuarial reduction

A participant has 30 years of creditable service at age 58 and elects the DB/DC conversion before beginning a bridge job. The participant will retire at age 61, at the termination of the bridge position. The formula benefit is calculated at 58 based on current earnings and service, then converted to a money purchase value and applied to the participant account. The WRS account continues to be credited with contributions and earnings during the bridge position. The final benefit that results at retirement at age 61 is based on the money purchase calculation.

Annuity at 61 after the DB/DC conversion at 58…	**Monthly Annuity**
…after full-time bridge job with a 20% pay reduction	$2,193
…after part-time (50%) bridge job	$2,170
Compared to transitional employment with no conversion and the annuity begins at 61…	
…after full-time bridge job with a 20% pay reduction	$1,725
…after part-time (50%) bridge job	$1,653
Compared to the expected benefit had career employment continued until age 61…	$1,885

Examples for Chapter 5 - Creating a Supplemental Income Stream

TABLE FF.- Bridge benefit option

A participant with 30 years of service at age 58 and intends to work in a bridge job for three years. The WRS formula annuity at age 58 would be $1,581 per month. The following illustrates a 25% and 50% bridge benefit plus the pop-up value at retirement after three years: 1) considering no additional credits to the WRS, and 2) how this would be impacted should the bridge position receive additional service credit. [For comparison purposes, without a bridge benefit and retiring at age 58, WRS benefit plus annual dividends would equal $1,992 monthly payment at age 61.]

Situation	25% bridge benefit	50% bridge benefit
Bridge Benefit	$395	$791
1) Pop-up Benefit – at age 61 No WRS credit for bridge job	$2,022	$1,924
2) Pop-up Benefit – at age 61 With WRS credit for bridge job[31]	$2,080	$1,963

A participant with 30 years of service at age 58 and intends to work in a bridge job for two years. The WRS formula annuity at age 60 would be $2,801 per month. The following illustrates a 25% and 50% bridge benefit plus the pop-up value at retirement, after two years: 1) considering no additional credits to the WRS, and 2) how this would be impacted should the bridge position receive additional service credit. [For comparison purposes, without a bridge benefit and retiring at age 60, WRS benefit plus annual dividends would equal $3,267 monthly payment at age 60.]

Situation	25% bridge benefit	50% bridge benefit
Bridge Benefit	$700	$1,401
1) Pop-up Benefit – at age 63 No WRS credit for bridge job	$3,294	$3,187
2) Pop-up Benefit – at age 63 With WRS credit for bridge job	$3,358	$3,229

[31] Earnings assumptions during the bridge job are: for 25% bridge benefit - annual earnings reduced by 25% the first year, then increased by 3% in subsequent years; 50% bridge benefit - annual earnings reduced by 50% the first year, then increased by 3% for each subsequent year

DEFFERED RETIREMENT OPTION PLAN (DROP) BASICS

What is a DROP?

A DROP can be designed to provide an incentive to employees to work past an early or normal retirement age. Some DROPs, however, may encourage employees to retire sooner than they might otherwise consider. A DROP is a type of distribution option under a qualified defined benefit plan, but it is not a separate qualified plan. It is funded through disbursements from a defined benefit (DB) plan and thus, past employer contributions to the DB plan. At the time an employee and employer enter into a DROP arrangement, instead of having additional contributions and years of service apply to the defined benefit value, the employee has a sum of money credited for each year of employment to a separate DROP account. The amount contributed to this account is based on the retirement annuity (formula benefit) the employee would otherwise be eligible to receive from the DB plan had he retired.

The DROP account usually earns interest. If actual investment earnings are credited to the amounts deposited into a DROP, the contributions may be considered annual additions to a defined contribution plan. However, if the account earns a predetermined amount of interest (e.g., 5%), the DB structure is maintained. This distinction is important because of the federal DC annual addition limits of 25% of compensation up to $35,000. It may be difficult for most employees who participate in a DROP to comply with the 25% of compensation limitation. A DROP can be designed to allow the participant to self-direct the investment of the DROP account.

Who is Eligible for a DROP?

Normally, employees can elect participation in a DROP when they become eligible for a retirement benefit under the DB plan. Employers can, however, establish other eligibility restrictions (e.g., minimum age and/or service requirements), or limit participation to a certain category of employees. Employees electing a DROP normally must specify a certain time period for the DROP and, in some cases, file a termination letter that cannot be revoked. In such cases, if retirement does not begin as planned, the DROP account is either forfeited and the account reestablished as if it never existed, or the DROP is frozen at a specific point in time and the contribution and service again applies to the original benefit calculation. This feature would be less likely if the objective of the DROP is to encourage people to delay their retirement.

Is There a Cost to the Plan to Operate a DROP?

Most plans try to set up the DROP to be cost neutral. This can be accomplished a number of ways such as:

- Reduce or eliminate the cost of living (dividend) adjustment to the annual benefit amount that is calculated when the DROP is initiated.
- Use a lower interest credit for the DROP balance (e.g., 5%) than that provided to active account balances (actual investment earnings).
- Reduce the beginning benefit that the employee would otherwise be eligible to receive if the DROP participation was not elected. Usually the reduction is removed when the person retires.

- Design the plan so that participation leads to a later retirement date.
- Some combination of the above.

What are the Advantages for Employees?

A DROP provides an opportunity to accrue benefits for those employees who have reached their maximum benefit amount under the DB plan. In addition, the employee has options available for payout at the time of final retirement. For example, the DROP can be paid as a lump sum to the participant, rolled into an IRA or calculated as a money purchase benefit to enhance the participants monthly annuity under the DB plan.

What are the Advantages for Employers?

With the advent of retiring baby-boomers, a DROP provides employers with an additional tool to use in retaining skilled, trained employees past their earliest retirement date. In addition, a DROP can allow an employer's human resource personnel to better plan for possible worker shortages as the DROP can be structured to require the participant to lock-in a specific retirement date and the employer will then know exactly when the employee will leave employment.

GLOSSARY OF TERMS

Terms used in the Transitional Retirement Study

Active participant - a participant who is covered by the Wisconsin Retirement System and actively employed

Actuarially reduced benefit - a formula benefit (defined benefit) that has been reduced based on the employee's age by an actuarially assigned age reduction factor

Actuarial reduction - when an employee retires before certain age and service requirements have been met, the formula benefit is reduced based on an age reduction factor

Annual dividend - the WRS declares an annual dividend based on the earnings of the trust that is applied to the benefit payments received by annuitants and beneficiaries

Annuitant - a participant who is receiving an annuity payment from the WRS is called an annuitant

Annuity - a benefit payment from the WRS that is over the life expectancy of the participant, or the participant and a joint survivor

Annuity reserve - the portion of the WRS trust that is held to fund distributions to annuitants and beneficiaries; when a benefit is initiated, the account value associated with this benefit is transferred to the annuity reserve

Baby-boom generation - Individuals who were born between 1946 and 1964.

Bridge job - a position that offers reduced hours or provides lower physical or mental stress than career employment and covers the time period between career employment and full-time retirement

Defined benefit plan - a retirement plan under which the employer provides a determinable benefit; in the WRS, this is the benefit resulting from a formula using years of service and three highest years earnings in the calculation

Defined contribution plan - a retirement plan that provides individual accounts for each participant, with the final benefit based on the value of the participant's account; in the WRS, this is the money purchase calculation

Dividend adjustment - same as the annual dividend, which is declared annually and applied to benefit payments received by annuitants and beneficiaries

Effective date - the date the benefit becomes effective

Effective rate interest - interest applied to participant's WRS account balances that is determined based on the investment earnings of the trust

Employee contributions - certain contributions to the WRS trust while a participant is actively employed are made by, or on behalf of, the employee and designated as employee contributions

Employer additional contributions - employers may make additional contributions to an active participant's WRS account, under Section 401(a) beyond the amount required to fund the formula benefit; this additional contribution applies to the final benefit as a separate money purchase benefit

Employer required contributions - employer required contributions are determined by the actuary to fund the WRS formula benefit

Formula benefit - years of service and the three highest years of earnings are used in the calculation to determine a participant's WRS formula benefit; this is the defined benefit feature of the WRS

Generation X - Includes individuals who were born between 1965 and 1979.

Minimum retirement age - participants must reach a minimum retirement age to be eligible for a WRS retirement annuity; the age is dependent on the employment category (e.g., general employees age is 55, protective category is 50)

Money purchase - the WRS benefit resulting from the accumulated account value; this is the defined contribution feature of the WRS

Participants - a current or prior employee who has a retirement account with the WRS

Participating employer - any public employer in Wisconsin that covers their employees under the WRS

Rehired annuitant - a WRS annuitant that has returned to work for a participating employer

Unreduced benefit - a benefit paid to a WRS participant after reaching the minimum age and service requirements; an age reduction factor is not applied to this benefit